BEFORE THE ARIZONA CORPORATION COMMISSION



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COMMISSIONER-CHAIRMAN
RENZ D. JENNINGS
COMMISSIONER
CARL J. KUNASEK
COMMISSIONER

IN THE MATTER OF THE COMPETITION IN THE PROVISION OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA.

DOCKET NO. RE-00000C-94-165

**STAFF'S REPLY BRIEF**

**INTRODUCTION.**

Many of the initial briefs filed in this proceeding, including Staff's, adopt a posture more of advocating and expounding on the party's position on the issues than of directly commenting on the positions of other parties. As a consequence, Staff believes that an extensive responsive brief is not warranted and would be unnecessarily burdensome on the Hearing Officer. Staff therefore is addressing in this brief only select issues where we believe additional comment may be of benefit. Of course, failure to address any particular issue or position of another party should not be taken as acquiescence by Staff to any other party's position.

**I. THE COMMISSION HAS THE AUTHORITY TO ESTABLISH RATE CAPS.**

As stated in our opening brief, Staff supports the utilization of a price cap during the transition period to guard against the unbundled rates of a utility totaling more than the standard offer. Some parties have raised questions about the Commission's legal ability to impose such a cap. (See, e.g., Arizona Public Service Company ("APS") Br. at 11; Arizona Electric Power Cooperative ("AEPCO") Br. at 11.) However, Staff believes that the processes contemplated by the Rules and envisioned by Staff will provide the necessary vehicle to allow the Commission to lawfully implement a price cap should it choose to do so.

A brief description of how Staff conceives of a "price cap" is a necessary starting point for this analysis. Staff views the "price cap" as merely ensuring that in unbundling its rates, as required by A.A.C. R14-2-1606.C, an Affected Utility does not set rates for the unbundled pieces which together add up to an amount greater than its old, bundled tariff. In other words, the sum of the generation price, the transition revenues allowed, transmission and distribution charge, and charges for other services should not exceed the customer's former, bundled tariff. (Ex. S-1 at 23.)

AEPCO argues that the Commission is required to set rates that provide an Affected Utility with the opportunity to earn a reasonable return on fair value ratebase. From this premise, AEPCO concludes that establishing a rate cap today "would, in fact, be confiscatory." (AEPCO Br. at 11.) Although AEPCO's premise is correct, its conclusion is not.

The Staff anticipates that in considering an Affected Utility's unbundled rates, system benefits charge, and "stranded cost" filings, the Commission will have before it all of the information necessary to determine the fair value rate base and rate of return of the utility. The Commission will be able to set the unbundled rates and system benefits charge, and determine the appropriate level of transition revenues, all within the context of a reasonable return on fair value rate base. Within this ratemaking process, the Staff fully anticipates that the Commission will make all required findings in setting the unbundled rates.

Where AEPCO reaches an incorrect conclusion is in assuming that the Commission cannot, in exercising its ratemaking authority, determine that a just and reasonable return can be achieved through capping the unbundled rates at the total of existing bundled rates. AEPCO correctly notes that a reasonable return must be determined at the time of inquiry, but fails to recognize that what is just and reasonable may be different during a period of transition to competition than during a period of monopoly pricing. Once the rate of return is determined, designing rates to provide the Affected Utility with the opportunity to earn that return is once again a matter solely within the Commission's discretion. It is the Staff recommendation that in designing those rates, the Commission should establish a cap as described above. This does not, contrary to AEPCO's assertions, automatically result in confiscatory rates as long as the opportunity exists to earn the authorized return.

Staff fully recognizes the Commission's constitutional obligations regarding fair value determinations and setting just and reasonable rates which continue to apply both during and after the transition period. The Retail Electric Competition Rules are set up to accommodate those requirements. The mere fact that the words "fair value" are not explicitly included in a given rule or testimony or brief should not be construed as meaning that the Commission will fail to comply with constitutional requirements.

## II. UNECONOMIC COSTS SHOULD NOT BE SECURITIZED.

Staff believes it important to take this opportunity to reiterate its opposition to securitization of uneconomic costs. This is a proposal most strongly advocated by Tucson Electric Power Company ("TEP"), which requests the ability to securitize up to 75% of its uneconomic costs. (TEP Br. at 22.)

The most serious drawback to securitization is, in a nutshell, that it transfers the risks associated with uneconomic costs from the Affected Uility to the rate payer. In order for securitization to be of benefit to an Affected Utility, any securities issued would have to be for a set amount and provide assurances that recovery is guaranteed for the life of the bond. (Ex. S-1 at 24-26.) These requirements ensure that two things will happen: first, ratepayers are left holding the bag in the event that competition does not result in as large an amount of uneconomic costs as is securitized; and second, the Affected Utility's "opportunity" to recover its uneconomic costs is transformed into a guarantee as it receives the full amount of the securities in cash. Ratepayers lose in both of those situations.

Staff believes that this transfer of risk entirely to the ratepayers is an inevitable and inappropriate result of securitization. Securitization should therefore not be utilized by the Commission as a vehicle to recover uneconomic costs.

## III. THE AFFECTED UTILITIES' PROPOSED USE OF "NET REVENUES LOST" IS INAPPROPRIATE.

Staff's transition revenues approach admits of using a "net revenues lost" calculation in estimating the dollar amounts of potentially uneconomic costs. As explained in our opening brief, there are several reasons that this methodology is acceptable in the context of Staff's proposal. First, it provides a reasonable estimation of the potential costs, without committing to a specific amount for recovery. Since the market conditions are unknowable until after full competition commences, it would be folly to pre-approve any specific amounts of potentially uneconomic costs for recovery. Perhaps more importantly, particularly when examined in comparison to the Affected Utilities' use of "net revenues lost", is the fact that the methodology can be employed in estimating uneconomic costs without requiring a change in ownership of generating assets. The auction and divestiture methods may give rise to an arguably "truer" estimation of uneconomic costs, but only if a real market is established for the generation assets. And, once done, divestiture is particularly difficult to undo. In addition, as we pointed out in our opening brief, the auction and divestiture methods only act to transfer uneconomic costs across categories, not as mitigation.

Since Staff's transition revenues approach allows uneconomic cost recovery to unfold as the actual market develops, the status quo can be maintained as to asset ownership, while still accommodating a fair opportunity for the Affected Utilities to recover their costs of providing service. Just and reasonable rates are authorized during the transition period, based on criteria established by the Commission, just as has been true under traditional regulation.

The Affected Utilities' proposals for the adoption of "net revenues lost" methodologies present tremendous difficulty. The APS proposal is particularly troubling. By proposing to use "net revenues lost" for both calculation and recovery, in conjunction with a limited transition period, the APS proposal appears to be aimed at maximizing utility revenues and minimizing consumer benefits from competition.

It is the unique combination of using "net revenues lost" for calculation and recovery, in conjunction with the limited transition, that causes this situation. As Citizens Utilities Company ("Citizens") noted in its opening brief, (Citizens Br. at 19 - 21), APS would calculate and recover uneconomic costs over precisely the period during which it is anticipated that existing generation will be least competitive in the market. Just at the time it is anticipated that market prices will catch up with (and pass) APS' embedded long run marginal costs of generation, the APS proposal would free it to maximize profits.

A general overview of just a couple of the alternative proposals reveals why the APS suggestion is so distorted. Any long run examination of the anticipated market reveals that the existence of uneconomic cost is likely to be a short term phenomenon. RUCO's proposal provides the best counterpoint to that of APS. By analyzing potential market prices in comparison to embedded costs over the expected life of APS' generating assets, Dr. Rosen concluded that APS would likely have negative stranded costs of about $838 million. (Ex. RUCO-1 at 9, Ex. RAR-4 at 1.) Dr. Rosen is not necessarily in conflict with APS analytically. He indicates a pattern that is similar to that found by the APS witnesses, he just carries the analysis to a later date.

Similarly, the parties proposing auction and divestiture generally believe that the market price of generation assets is likely to exceed the Affected Utilities' embedded costs, i.e., book value. This phenomenon is thought to be the case today, but will certainly accelerate with the passage of time, since the continued depreciation of generation assets will not directly impact the market price of electric generation. Since the market value of the assets is a function of the revenue stream they may generate, the more depreciation already recovered from captive ratepayers, the more a given asset is worth by comparison to its embedded cost.

Finally, it is necessary to remember that all of the market values, as well as the projections of revenues anticipated under continued regulation are only that, estimates. No one knows what the market price for electric generation will be in Arizona once a fully competitive market is established. Nor do they know what revenues would be actually received by any of the Affected Utilities if traditional regulation continued. Consequently, it is important to continue to think in terms of potentially uneconomic costs, and not to fall into the trap of trying to devise a plan that is based on a specific projection of those potentially uneconomic costs. Staff's proposed transition revenues approach places the Affected Utilities into familiar surroundings, very much like a continuation of traditional regulation. Based on criteria that will be established by the Commission, on a utility specific basis, the Affected Utilities will have the opportunity to recover their costs of providing service, including a fair return on the value of the property devoted to providing that service. The purpose of a transition period is to provide a transition to a fully competitive market. Only Staff's approach maintains the appropriate incentives for all parties concerned during that transition period.

## IV. CONCLUSION.

Staff continues to believe that the transition revenues approach to uneconomic costs is the superior approach. The Staff recommendations provide the Commission with maximum

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flexibility to address the individual circumstances of each Affected Utility. Therefore, Staff respectfully requests that its recommendations in this matter be adopted.

RESPECTFULLY SUBMITTED this 23rd day of March, 1998.

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